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*Review*

## **Annual Report of the Central Bank 2010**

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The Central Bank of Sri Lanka (CBSL) probably is one of very few government institutions in Sri Lanka that publishes its annual report on time. The Monetary Law Act requires it to do so within four months from the end of each financial year. The Bank has never failed to meet this deadline in its sixty one years of existence. Even if there are other government agencies that are as punctual, there probably is not one among them that is as comprehensive in reporting on the field that it covers.

The 2010 Annual report that runs into more than 580 pages was published recently. It catches the attention of the media for a few days, but then tends to fade away from public view. Perhaps the report is too technical and detailed to catch the popular imagination. In any event, although cost of living, poverty eradication and “development” are popular themes in the media, Economics even in a slightly technical form is not a popular subject of public discourse.

The main job of the CB is to preserve price stability and help maintain high and steady rate of economic growth and high level of employment. These goals, if achieved, denote macroeconomic success. These are goals common to all central banks in the world. A central bank has only limited tools and power to make them happen. The power of a central bank in a developing country such as Sri Lanka is even more limited than that of, say, US (Federal Reserve Bank) or the UK (Bank of England) because developing country economies usually do not have strong financial institutional structures that CBs can regulate and direct to move an economy in the direction that they desire. For sure, CBSL can influence the interest rates (cost of credit) of banks to some degree. It can also regulate to some extent the level of bank lending. However, bank lending to and borrowing by consumers and investors are dependent on multiple factors and credit availability and interest rates may not even be decisive in lending/borrowing decisions.

No central bank in the world has direct power over fiscal policy – taxes and government spending and government borrowing. That is the prerogative of the Treasury or Finance Ministry. CBSL can, within limits, control the exchange rate between the SL rupee and the dollar and other major currencies. That exerts an influence on imports and exports. But both exports and imports are also driven by factors other than the exchange rate. CBSL Annual Report must be reviewed in the above context of limits of what CBSL can actually do to move the economy.

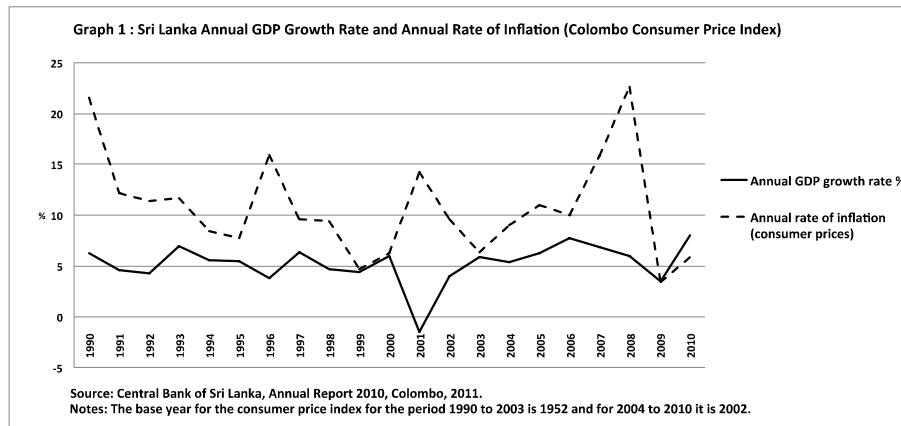
The 2010 Annual report is a tome that runs close to 600 pages. In contrast the first report issued in 1950 was a slim volume. The growth of the report mainly reflects an expansion of coverage and, to a lesser extent, the diversification and

increasing complexity of the economy. For example, in the 1950s a few commercial banks dominated the financial sector. Today the financial sector is far more diverse. Tea, rubber and coconut dominated exports and there was no apparel manufacturing, tourism was hardly noticed and there were no migrants workers sending back billions of dollars in remittances.

The 2010 Report consists of four parts, a statistical appendix and a special statistical appendix. The meat of the report is Part I that is about 190 pages or about one third of the entire report. Parts II, III and IV that account for about 40% of the report deal with administrative and legal matters pertaining to the Bank and its policies and may be of greater interest to specialists than to the general public. The Statistical Appendix reports a variety of data from national income accounts to inflation and bank credit. A large proportion of the data in this section originates from the Department of Census and Statistics, Ministry of Finance and other government agencies dealing with the economy. The Central Bank is the main source for money and banking data. The Special Statistical Appendix that gives time series data from the early 1950s for a variety of demographic, economic and social variables is especially useful to researchers interested in studying Sri Lanka's long term development trends.

The year 2009 was not a very good year for the Sri Lankan economy. GDP growth was down from 6.0% in 2008 to 3.5%. The overall budget deficit at 9.8% was the highest since the record 10.4% deficit in 2002. In 2009 Sri Lanka used 19.0% of its export earning to service the foreign debt, the highest ever debt service ratio recorded in the past two decades. As the CB Report points out, the macroeconomic numbers showed considerable improvement in 2010. GDP growth was 8.0%, the budget deficit declined to 7.9% and the debt service ratio to 15.0%. Unemployment rate was a record low at 4.9% although this ignores serious underemployment that exists in the country.

Some of these improvements were partly the "peace dividend" that came when the war ended. More investment in civilian infrastructure development and the greater contribution from the north and east to the national economy are the most notable examples. However, the better economic performance in 2010 was also partly, perhaps mainly, the result of external factor. Industrial exports went up by 20% in volume and 9% in prices. While the volume of total agricultural exports hardly changed, prices rose by 8% with rubber and tea leading the way. Thanks largely to global market conditions the country's export earning were up by as much as 32%. Our migrant workers added \$4.1 billion in foreign exchange remittances. These were all for the good of the national economy.



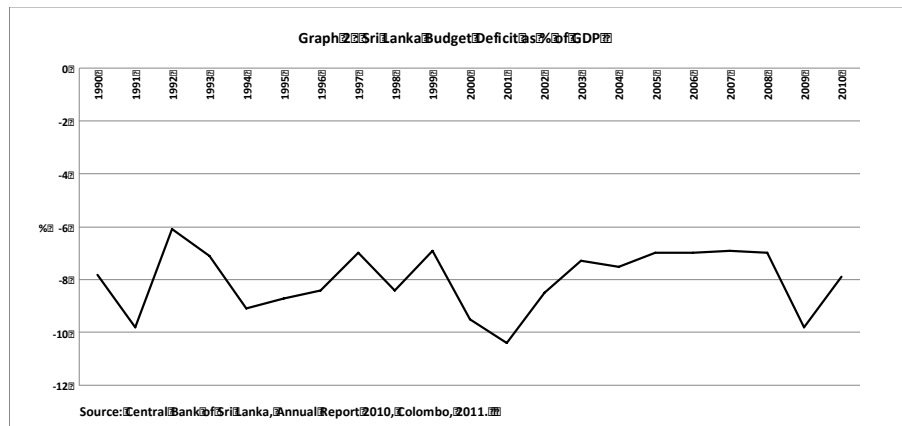
With the war ended and good economic numbers in 2010 the government was so upbeat that it made a forecast last April that the country would be able to double GDP per capita from \$2,399 in 2010 to about \$4,800 by 2015. This requires an annual compound growth rate of nearly 15% not allowing for population growth. (To be fair the Central Bank Report projects a medium term economic growth rate of 8% per annum that is far more realistic.) As Graph 1 shows, in the past two decades Sri Lanka's actual GDP growth rate has fluctuated around 5% to 6%. In the last sixty years GDP growth reached 8.0 or more only in three years, 2010 (8.0%) after the war ended, 1978 (8.2%) the first year of Jayewardene's open economy and 1968 (8.2%) when the Dudley Senanayaka regime partially liberalized the economy devaluing the rupee and easing foreign exchange control. In that year good weather and government support for agriculture boosted rice production in particular.

Note that all three years identified above were not quite normal. That does not mean that Sri Lanka cannot increase its GDP growth rate to, say, an average of 10%. China has done it in the past two to three decades and India's ambition is the same. However, such an outcome requires radical economic reform that is not necessarily politically popular. For example, the current policy of keeping the rupee exchange rate below Rs 110 per US dollar helps control inflation and makes the consumers (voters) happy. However, with rising cost of production an over-valued rupee also makes Sri Lankan exports less competitive. China, whose high GDP growth rate is largely dependent on exports, follows the opposite policy of keeping its currency Yuan *undervalued* much to the displeasure of USA.

The CB Annual Report is not an economic planning document. However, it provides the basic data that tells us what we should do if the country really wants to achieve a growth rate of 10% let alone 15%. Here are a few pointers. In the past twenty years Sri Lanka annually invested, on average, about 25% of GDP that produced a growth rate of about 5% to 6%. That means for each 4 to 5 percentage points of investment we obtained one percentage point of growth. One way to double the growth rate to 10% is to invest not 25% but 50% of GDP assuming that the new investment would be as productive as the old. That may or may not happen. In fact the current infrastructure-led investment strategy may not yield even 1 percentage point of growth for every additional 5

percentage points of investment because typically roads, seaports, airports, buildings and so forth take a longer time to yield a pay back. If the investment choices are bad – e.g. Mihin Air – the results will be negative.

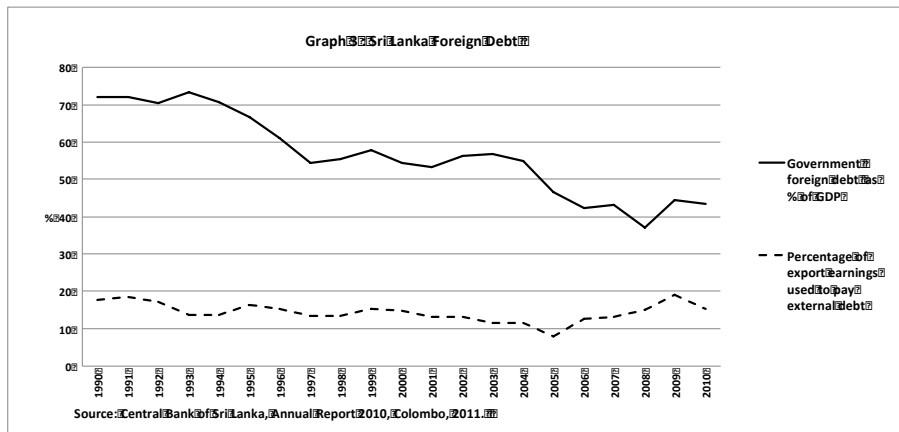
Even if we assume that we make very wise choices in investment the question arises as to from where the money would come for the additional investment. In the past few decades Sri Lanka's own savings provided, on average, about 20% to 22% of the funds required for investment. It is not realistic to expect domestic savings to suddenly increase from the current 20% to 22% of GDP to 40% or more. The government's capacity to collect additional taxes based on the current tax rates is very limited. It is also finding it difficult to raise tax rates.



The government's budget deficit reached an unsustainable 10.4% in 2001 (Graph 2) After that it was in the 7% range but jumped to 9.8% in 2009. The IMF gave a standby loan of \$2.6 billion in 2009 on the condition that the budget deficit would be cut from a then estimated 7% of GDP in 2009 to 5% by 2011. In reality the deficit was 9.8% in 2009. In 2010 it was 7.9%. The deficit projected for 2011 is 6.8%, well above the IMF target. IMF has ignored its own terms and continues to disburse the stand by loan. However, the fact is deficit financing is not an option to increase investment.

In the household sector middle-income group and the poor have little or no capacity for additional private savings. The fierce opposition of some private sector workers to the government proposal to take 2% of their earnings – in effect a form of forced saving – in exchange for a retirement pension is evidence of this situation.

The richest 20% in Sri Lanka get about 52% of the country's income. They have the most capacity to save or pay taxes. However, it is unlikely that even they would be able to save much more than what they do currently to help finance double the current rate of investment. That means we have to rely on foreign funds.



The foreign debt of the government as a percentage of GDP declined from the early 1990s to 2008 (Graph 3). In the past few years the government has borrowed quite heavily from commercial sources reversing the trend. Such borrowing has also caused the share of export earnings that we have to set aside to pay the foreign debt to increase after 2006. These are not sustainable trends in national finances.

Theoretically the best option we have to raise our investment level and hence the rate of economic growth is to attract Foreign Direct Investment (FDI). According CB data \$691m in FDI that we got in 2008 was the highest amount that we got in recent years. This was while the war was raging. One would expect more FDI after the war ended as a part of the peace dividend. However, in reality FDI in 2009 and 2010 were \$ 384m and \$435m respectively. There are signs that sectors such as tourism are attracting more FDI. However, we need FDI in multiple billions of dollars, especially in manufacturing, to make a real difference to investment and growth. This requires a very systematic and well thought out development strategy.

The CB Annual Report is mostly a narrative of economic numbers and events with not much analysis. Perhaps it is unfair to expect such a report to be more analytical and critical. In any event bureaucrats who write such reports are expected to be circumspect in their comments. The result is that the report more or less compartmentalizes the different parts of the economy and leaves the job of connecting the dots to others. For example, As Graph 1 shows between 1999 and 2008 inflation shows a rising trend. This has consequences for income distribution and living standards. Between 2006 and 2010 consumer prices have gone up by about 55%. Roughly during the same period the household average income increased only by about 35% suggesting a significant decline in real income. Not surprisingly the share of income spent by the average household on food went up from 37.6% to 39.2% and the share spent on durable consumer goods went down from 3.4% to 2.9% indicating the difficulties that households faced in meeting day to day living expenses.